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NAFA

NATIONAL ASSOCIATION OF FLEET ADMINISTRATORS, INC.
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Can the U.S. Industry Become Competitive Again?

The very thought that the question of whether the United States automobile industry will survive may seem ridiculous, but the question was raised — with some disturbing answers — by a report submitted to the U.S. Senate Committee on Finance, Subcommittee on International Trade last month. The report was prepared by the Bureau of Industrial Economics, Department of Commerce; International Trade Administration, Department of Commerce, and the Transportation Systems Center, Department of Transportation.

As the largest volume customers of the U.S. automobile industry, NAFA members and affiliates must be concerned with the implications of the "Status Report — United States Automobile Industry." This article is based on that report.

Sales of domestic-made automobiles are down a third from the 1978 peak. Sales of imports are up 15 percent from 1978. There is no prospect for a sharp turnaround in the immediate future. Cyclical factors only partially account for industry difficulties. A fundamental shift downward in the long run demand for automobiles, and some categories of trucks, has also become evident and can be expected to continue. Domestic producers are not cost competitive with Japanese producers.

Poor sales have resulted in losses for the auto manufacturers. More important, they have resulted in large negative cash flows for the auto companies. The erosion of the financial strength of the auto companies is best illustrated by the combined working capital position of the Big Four (GM, Ford, Chrysler, and AMC), which has fallen from $13 billion at year end 1978 to $300 million at the end of the third quarter of 1981.

Companies Forced to Act

Given the severe cash flow pressures, the auto companies may be forced to pursue any of the following actions:

- **Postponements of modernizing investments**
- **Shutdowns of excess capacity**
- **Increases in foreign sourcing**
- **Curtailments of wage gains**
- **Infusions of large external financing**

There are ample signs that the companies are already pursuing combinations of these approaches. Although the analysis in this report suggests that all these steps may be required to preserve industry liquidity, the question remains whether the industry can do this and restore long-run competitiveness at the same time. A revived economy is the only change that can be realistically expected to remedy the industry's condition. And, even then, reduced demand growth will make it difficult for domestic producers to return to the sales and profit years of decades past. Pressure to find new jobs for displaced auto workers can be expected to persist.

Following severe declines in 1979 and 1980, new passenger car retail sales will drop another three percent in 1981 to an estimated total of only 8.7 million units. From the 1978 peak, new car sales will end 1981 down 22 percent. Sales of domestically-produced cars are being particularly hard hit, falling to about 6.3 million units for the year, a drop of 31 percent from the 1978 peak.

Reflecting a combination of uncertain economic conditions, high interest rates, and high car prices, sales of domestic-make cars have been sluggish all year, save for two periods (February-March and August-September) when manufacturers offered rebates and other incentives.

Although industry analysts earlier had expected the new car market to begin a recovery in the fourth quarter, it is now apparent that the long awaited upturn will occur no earlier than late winter or early spring. To counter the weak market,

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manufacturers have been offering a series of sales incentive programs. Incentives so early in a model year are unprecedented.

In contrast to domestic-make car sales, imported car sales have been at or near record levels since the sharp rise in gasoline prices in 1979. Import penetration, at 17.9 percent of the market in 1978, reached 26.7 percent in 1980. Peaking at 29.6 percent in July, import penetration will average an estimated 26.5 percent for 1981. The share would have been higher this year had Japan not imposed export restraints on its car manufacturers.

Japanese products have dominated the import market since 1979, consistently accounting for about 80 percent of imported car sales. Because of the general weakness of the auto market and Japan's export restraining program, import sales are expected to decline four percent from last year's record level to a total of 2.2 million cars for 1981.

One of the most noteworthy developments in recent years has been the dramatic shift of consumer demand to smaller, more fuel-efficient cars. Small cars (sub-compacts and compacts) including imports accounted for 47 percent of total new car sales in 1978. Their market share increased to 55 percent in 1979 and 62 percent in 1980 and will reach an estimated 64 perent in 1981. The share for small cars now appears to be leveling off, however, with considerable uncertainty as to the future trend.

Domestic car producers were not prepared for the abrupt shift in consumer preference to smaller cars. When the change began in earnest in the spring of 1979, only two families of domestically produced "new design" small cars (front wheel drive) were available. Lacking production capacity for "new design" small cars, domestic manufacturers lost substantial market share to imports during 1979 and 1980. Since 1979, the domestic industry has introduced additional new small models and converted substantial production capacity to their manufacture. The companies, therefore, now have capacity to produce four million "new design" small cars annually, compared to a 1981 annual sales rate of only about 2.1 million units.

Poor Sales Restrain Output

Sluggish sales and high inventories have restrained domestic output over the past several months. Production schedules have been cut back repeatedly to regain control of inventories. Based on current schedules, domestic production for 1981 will total a disappointing 6.3 million cars, 1.6 percent below last year's output, and the lowest since 1961. Domestic light truck output is no more promising, with only 1.55 million units scheduled for assembly this year. Although 11 percent above a year ago, 1981's light truck output will be 53 percent below the 1978 record.

Since late 1979, unemployment has been widespread in the industry. Unemployment peaked in August 1980 with 250,000 production workers — 32 percent of the hourly work force — and 50,000 salaried workers indefinitely laid off by the manufacturers. At the same time, unemployment among domestic parts and component manufacturers, and other automotive suppliers, reached an estimated 650,000.

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Movements in Cost of Operating a Car, January 1978-September 1981
(BLS price indexes seasonally adjusted converted to January 1978 = 100)

	Repairs and Maintenance	Gasoline	Other Personal[1] Transportation Commodities	Other Personal[2] Transportation Services	Total Operating, Repair, Finance and Insurance Costs[3]
January 1978	100.0	100.0	100.0	100.0	100.0
January 1979	109.1	110.2	106.9	105.1	108.0
January 1980	120.3	176.3	121.6	114.4	142.2
January 1981	133.4	203.1	131.5	127.4	160.9
October 1981	142.1	213.0	137.2	136.7	170.0

[1]Includes motor oil, coolant, tires and other vehicle parts and equipment.

[2]Includes insurance, auto finance charges, vehicle registration, rental fees.

[3]Combines price indexes for component elements with the following December 1977 price relatives: Repairs 1.516; gasoline 4.205; other transportation commodities 0.733; other transportation services 3.416.

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The probability of automotive employment ever recovering to its 1978 peak is low. At that time, the U.S. auto industry indirectly employed approximately 1 million workers with another 1.4 million employed by the automotive supplier industry. Based on current projections of slow growth in domestic automotive demand and assuming the productivity gains required for regaining international competitiveness, the automotive industry, in comparison with the 1978 peak, will employ approximately 200,000 fewer workers in the mid-1980's. The supplier industry may suffer an employment loss in the range of 300,000 to 400,000 workers from the 1978 total.

In addition to the motor vehicle manufacturers and their suppliers, franchised dealers have also been severely affected by the depressed automotive market. Since 1979, 2,600 new car dealerships — 10 percent of the total — have closed; approximately 100,000 dealer employees have been laid off.

Interest Rates Deter Sales

High interest rates are often identified as a major deterrent to new car sales. Potential (retail) buyers certainly consider rates and total interest charges as part of the purchasing decision. Interest costs increased by 76 percent from the first quarter of 1978 to the third quarter of 1981. However, the magnitude of the monthly payment tends to be the more important consideration. In this regard, average new car payments as a percent of disposable personal income per household declined slightly from 1978 to 1980, in spite of car prices averaging 48 percent higher and auto loan interest rates increasing from 13 to 16 percent during this period.

The rise in monthly payments was somewhat constrained by an increase in loan duration from 42.9 to 45.1 months. Although higher this year than in 1980, car payments as a percent of disposable personal income per household are lower than in 1976 and 1977, when the new car market was healthy. Even though interest rates may not be the primary factor affecting new car purchase decisions, they do have an adverse psychological impact on prospective buyers and also result in lending institutions being more restrictive with their funds. The disqualification rate for new car loans has been higher than normal in recent months.

Yearly Expenditures on Personal Transportation As a Percent of Personal Consumption

Year	Motor Vehicle and Parts	Gasoline and Oil	Services	Total
1970	5.8%	3.6%	2.5%	11.9%
1971	6.8%	3.6%	2.7%	13.1%
1972	7.1%	3.4%	2.7%	13.2%
1973	7.0%	3.5%	2.5%	13.0%
1974	5.6%	4.1%	2.4%	12.1%
1975	5.7%	4.1%	2.4%	12.2%
1976	6.7%	4.1%	2.5%	13.3%
1977	7.1%	4.0%	2.7%	13.8%
1978	7.0%	3.9%	2.7%	13.6%
1979	6.3%	4.5%	2.8%	13.6%
1980	5.5%	5.1%	2.6%	13.2%

Trend of Domestic vs. Imported New Car Prices 1978 to 1981 by Quarter

		Average domestic car price*	Average imported car price*	Average price for all new cars
1978	Q1	$6,237	$5,511	$6,096
	Q2	6,452	5,787	6,338
	Q3	6,578	6,007	6,476
	Q4	6,633	6,541	6,617
1979	Q1	6,790	6,597	6,751
	Q2	6,709	6,670	6,700
	Q3	7,011	6,930	6,995
	Q4	7,084	6,741	7,001
1980	Q1	7,303	7,445	7,340
	Q2	7,474	7,271	7,418
	Q3	7,741	7,497	7,676
	Q4	8,085	7,549	7,938
1981	Q1	8,129	8,208	8,150
	Q2	8,501	8,910	8,618
	Q3	8,988	9,125	9,020

* Average new car prices computed by the Bureau of Economic Analysis.

"In addition to the motor vehicle manufacturers and their suppliers, franchised dealers have also been severely affected by the depressed market."

Revenue of the Big Four automakers fell from $122 billion in 1978 to $106 billion in 1980, recovering only to an estimated $111 billion in 1981. Over the same period net income fell from a profit of $5 billion in 1978 to a $4.2 billion loss in 1980 and an estimated loss of $1.4 billion in 1981. The estimate of 1981 net income is heavily dependent upon assumptions concerning tax credits. In the third quarter of 1981, tax credits of $700 million significantly reduced the size of the net income loss.

Since 1978, cash flow pressures have been intense. The Big Four experienced negative cash flows of $2.5 billion in 1979 and $9.1 billion in 1980. Depending on assumptions for the fourth quarter, the 1981 cash flow could be negative by as much as $6.4 billion. The most startling trend of all is the drastic rundown in the working capital of auto producers. At year end 1978 their combined working capital was $13 billion; at the close of the third quarter of 1981 their actual working capital was $300 million. By the end of 1981 they could be

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showing, combined, a zero working capital. Under pessimistic assumptions it could fall to a negative $900 million.

Estimates for the total cost of the 1978 through 1985 changeover for United States/Canada operations of the domestic motor vehicle industry, including start-up costs, run around $65 billion. The Transportation Systems Center estimates that roughly half of this investment program has now been completed. As this report makes clear, however, severe cash flow pressures could force the auto manufacturers to postpone completion of the second half of the program. In recent months announcements of investment stretchouts or postponements have become regular features in the auto trade press.

Machine Tool Sales Suffer

A recent survey among machine tool manufacturers suggests that cancellations by the auto producers will amount to a loss of $1.5 billion to $2.0 billion in machine tool business. New orders for automotive machine tools are currently running at no more than 50 percent of their level in 1980.

Unlike the previous automotive industry recessions, the present slump is not entirely cyclical in nature. In addition to cyclical influences, the downturn in domestic-make sales also reflects an apparent slowdown in the long-term growth of demand for automobiles together with the impact of sharply intensified international competition for the U.S. market. The slower growth rate for automotive demand results from demographic factors, the erosion of consumer purchasing power by inflation, and the sizeable increase in the relative price of owning and operating a car.

The recent decline in the growth rate of the driving age population has slowed the growth of automotive demand. Between 1979 and 1980, the growth rate of persons aged 18-24 (which includes many first-time car buyers) was less than half of the 2.3 percent annual growth rate between 1970 and 1975. Moreover, the number of people in this age group will actually decline by 1985.

The rate of increase in consumers' real income has slowed markedly over the past five years. Moreover, because prices for food, energy, and shelter have increased at a more rapid pace than other items, the squeeze on discretionary real income has been even more pronounced. Improvement in real income is critical to the restoration of a more normal level of car buying.

"Reflecting a combination of uncertain economic conditions, high interest rates, and high car prices, sales of domestic-make cars have been sluggish all year . . ."

Over the period 1971-1980, consumers spent a relatively constant share of their total expenditures on owning and operating automobiles. These outlays include purchase of new and used cars, gasoline and oil, insurance, financing costs, repair, leasing, and other service fees. The automotive-related share varied from a low of 11.9 percent of personal consumption expenditures in 1970 to a high of 13.8 percent in 1977. During the first half of 1981, the share was 13.2 percent despite depressed new car sales — a consequence of rapidly rising costs of financing, insuring, maintaining, and operating a car. Since January 1978, these costs have increased by 70 percent, more than double the 34 percent increase in new car prices.

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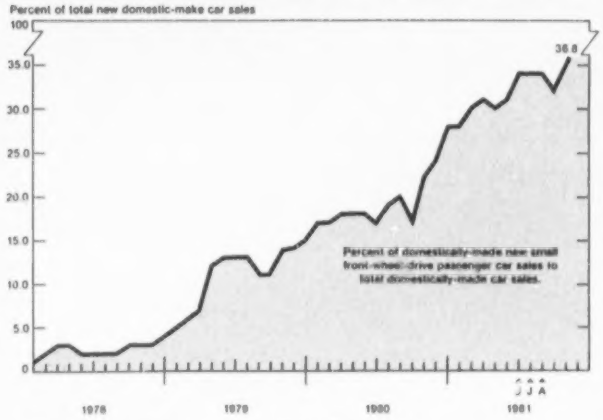
NEW DOMESTIC-MAKE SMALL FRONT WHEEL-DRIVE PASSENGER CAR* RETAIL SALES



*Small passenger cars include subcompacts and compacts.

NEW SMALL PASSENGER CAR* SALES (Including Imports)

*Small passenger cars include subcompacts and compacts.

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Higher gasoline prices, which have increased annual fuel costs almost $500 per car since 1972, have an additional effect on long-term automotive demand. In response to higher gasoline prices, consumers are changing their driving habits. The average number of miles driven per year has dropped from 10,184 per car in 1972 to an estimated 9,400 miles in 1980. The reduced usage of cars can be expected to lead, ultimately, to lower replacement demand.

"The slower growth rate for automotive demand results from demographic factors, the erosion of consumer purchasing power by inflation, and the sizeable increase in the relative price of owning and operating a car."

Consumer perceptions of the quality of domestic cars relative to imports, in particular Japanese produced vehicles, are undoubtedly an important factor in the current domestic car sales slump. Several recent consumer attitude surveys show consistently higher quality ratings for imports. A poor quality image is difficult to turn around and the shift unfortunately requires an extended period of time. Quality is fundamentally a question of the priority which management and labor are willing to assign it. There is considerable evidence that both groups now recognize its importance to the industry's recovery. Achievement of quality levels competitive with imports — and consumer recognition of this condition — is certainly imperative for domestic industry recovery.

Lack of competitiveness in manufacturing costs threatens the U.S. auto industry's long-term viability and is its most difficult challenge. Japanese manufacturing costs are substantially below U.S. costs for a comparable car, due to lower hourly compensation, productivity advantages from a more advanced manufacturing technology, and more effective systems for controlling inventory, product quality, and workplace activity. Recent studies indicate Japanese manufacturers can land cars in this country for as much as $1,000 to $1,500 per car less than U.S. producers can deliver comparable vehicles to the same destinations.

Increased Foreign Sourcing

One means by which auto manufacturers are trying to reduce costs and become more competitive is through increased foreign sourcing. The Transportation System Center closely monitors projected foreign sourcing plans of the domestic auto manufacturers. Based on what the companies have publicly announced over the last year or so, it is estimated that during the 1982-84 period, in any single year, the domestic producers may be drawing on foreign sources for the following quantities of auto components:

Item	Million Units
Engines	2.5
Transaxles	1.7
Aluminum Cylinder Heads	1.3
Alternators/Starters	1.5
Wiring Harnesses	5.0
Rear disk Brakes	.5
Constant Velocity Joints	.6

It should be noted that these figures stand totally apart from traditional imports of replacement parts for both U.S. made and imported vehicles. Rough estimates of what the list might add up to in dollar terms is about $2.5 billion.

Modernization of Facilities

A substantial portion of the industry's current investment program involves the modernization of manufacturing facilities to achieve the productivity improvements necessary for regaining international competitiveness. The eventual success of this program, which planned for completion by the mid-1980's, is difficult to predict, particularly in view of the unfavorable near term cash flow outlook and the already announced postponement of some investment plans. In addition, the Japanese industry will not be standing still during this period and can be expected to enhance its competitive position with further product and manufacturing advances.

New Car Payments as Percent of Disposable Personal Income per Household

Average Car Loan

	Contract Price	Interest Rate	Loan Duration	Lifetime Interest Expense	Monthly Payment	Payment as of Disp. Pers. Income
1978	$5696	13.1%	42.' Mos.	$1460	$166.81	10.4%
1979	$6046	13.5%	44.3 Mos.	$1667	$174.11	9.8%
1980	$6476	14.9%	44.7 Mos.	$1993	$189.47	9.9%
1981	$7654	16.0%	45.1 Mos.	$2576	$226.84	10.9%

* Average new car monthly payment as a percent of Disposable Personal Income per household.

Commensurate with the uncertain outlook regarding the length and depth of the current recession, forecasts of 1982 U.S. new car sales currently vary widely. Three months ago most forecasts fell within the 10.0 to 10.5 million range; currently the forecasts are between 9.0 and 9.5 million cars, including 2.3 to 2.4 million imports. The outlook is for continuing heavy cash flow pressures on the domestic indus-

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try until late 1982. Industry analysts are still expecting the recovery to generate high volume sales in 1983 and 1984.

Manufacturers Face Challenge

Although the pressures on cash flow will ease as the industry recovers from the recession, profits may still be relatively low and financing of investment difficult. The larger-size cars and the luxury models have historically had higher profit margins, while small cars generally have had low, and in some instances, negative margins. Average profit margins will tend to be held down as small cars increase their market share. This situation reflects the influence of import pricing, which, to a considerable degree, controls domestic small-car pricing. To achieve some degree of profitability in the small car business, domestic manufacturers will promote optional equipment and introduce small luxury and specialty models. During the 1980's, manufacturers will face a major challenge in developing a fleet of cars with a product mix that can provide an adequate return on investment. ■

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